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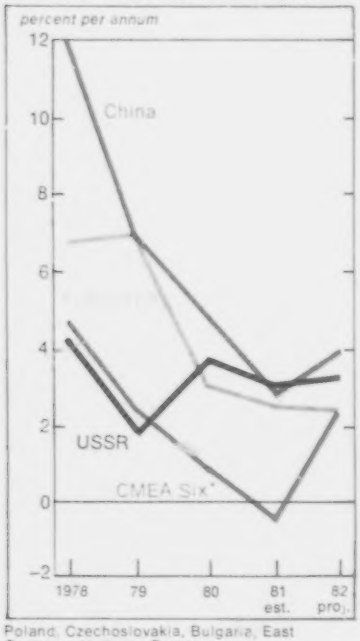
Protracted Austerity for the Centrally Planned Economies

As the OECD countries look toward a modest recovery in 1982, economic policy austerity will continue to dominate the centrally planned economies of Eastern Europe, the Soviet Union, and China. The shift from expansionary to restrictive policies in the Communist economies emerged as early as 1979 in Poland and Hungary, and slow growth and painful adjustment are likely to persist through the first half of the decade. The primary reasons for the growth slowdown include rising relative prices for and inefficient utilization of energy and raw materials; poor agricultural performance, especially in Poland and the USSR; growing external debt burdens, aggravated by high real interest rates in the West and the strength of the U.S. dollar; and long-standing problems of labor productivity and social unrest, most conspicuous in Poland but haunting all Communist leaderships.

National income growth of Communist economies



* Poland, Czechoslovakia, Bulgaria, East Germany, Hungary, Romania

Communist governments have reacted with policy changes rather than organizational reforms. Investment spending and machinery imports have been cut, government expenditures and real personal incomes have been reduced, and domestic price levels have been boosted. The real-income decline has been most dramatic in Poland—which has witnessed a drop of about 25% since 1978—but Czechoslovakia, Hungary, and Yugoslavia have also seen significant income erosions. Many growth targets in the new five-year plans (through 1985) have been revised downward, and little growth is projected for capital investment during the period.

Reflecting the sustained austerity, the aggregate hard-currency trade deficit of the centrally planned economies has not deteriorated since 1978, although individual country balances have changed. Restrictions on non-grain imports, as well as fuel-export revenues earned by the Soviet Union and China, have contained the aggregate external deficit. The chief exception to this trend, however, has been the USSR; its trade balance swung into deficit by $4-5 billion in 1981. The shortfall absorbed half the USSR's foreign-exchange reserves held in Western banks and prompted increased Soviet gold sales. As for the East European Six, their diminished demands for credit from the West reduced their net liabilities to Western banks by $2 billion in the first half of 1981. Faced with resistance, Poland began to reschedule its debt, while Romania delayed its payments to foreign firms and borrowed from the IMF. China and Yugoslavia relied more heavily on the multilateral agencies, seeking larger assistance from both the World Bank and the IMF.

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Anemic growth with easing inflation seen for Canada.

The pace of Canadian economic activity is expected to be slow or stagnant at least through June, continuing the decline that set in during the third quarter of last year. The sluggishness is mainly the result of the U.S. recession. But it is being reinforced by fiscal and monetary policies that have remained restrictive to reduce an inflation rate that reached 12.5% in 1981. If the U.S. economy rebounds in the latter half of 1982, Canadian growth should also accelerate gradually. Nonetheless, 1982 GDP growth forecasts call for a 1% advance at best. The lessened demand pressures, however, along with lower food and interest costs, should permit substantial reductions in Canada's inflation rate over the course of the year—perhaps to the 10% range.

Consumer spending and exports fuel French recovery.

Data now confirm a pick-up in French economic activity beginning in the second quarter of 1981. Real GDP was up at a 2.4% annual clip in the third quarter, following 5.2% annual growth in the second quarter. The recovery reflects increased consumer spending and export strength, and is being fed by an expansionary fiscal and monetary policy. Real GDP growth in 1982 is likely to be about 3% on a year-average basis, following 0.5% growth in 1981. Inflation, however, is persistently high, and the balance-of-payments deficit continues to grow. The current-account deficit for 1981 is likely to have changed little from the 30-billion-franc deficit recorded in 1980. It may widen to more than 50 billion francs this year. And inflation is unlikely to recede much from its current level of 14%. Inflation and balance-of-payments difficulties will place the franc under downward pressure within the European Monetary System, which will intensify if the German mark recovers strongly in the first half of 1982 as many expect. Franc interest rates may then have to rise to quell speculation prior to any EMS realignment.

Belgium's new government acts to reduce fiscal and external deficits.

The new center-right coalition government of Wilfried Martens won a vote of confidence in Parliament, and will initiate measures to correct Belgium's economic imbalances. The government will seek to modify the country's system of wage indexation to achieve a 3% cut in real incomes and limit the 1982 budget deficit to 200 billion Belgian francs, instead of the 327 billion francs now foreseen. Both measures are needed to correct the country's growing imbalances: a current-account deficit of over $6 billion (more than 5% of GNP) and a public-sector deficit expected to reach 16% of GNP this year on unchanged policies. The foreign-exchange markets have reacted favorably to the new government. However, a successful loosening of wage indexation would give the authorities even more freedom to adjust the exchange rate, as higher import prices would no longer necessarily lead to higher wages.

Philippine economic weakness expected to continue.

The year just past appears to have been the poorest in some time for the Philippine economy. Although the government has not yet revised its mid-year estimate of 5% growth in real output for 1981, sectoral data suggest that projection is highly optimistic. Manufacturing output in the first half was off by 7%, and imports, except for oil, were well down in volume terms from 1980. Energy consumption declined. And about two-thirds of large Philippine firms surveyed were reported running in the red. The 1982 growth outlook is for continued weakness, although some improvement is likely. Given the prospective sluggishness of the industrialized economies, only moderate increases in export prices or volumes can be expected. With private investment demand continuing depressed, the government is moving toward a more expansionary fiscal policy. Its room for maneuver, however, is sharply limited by a current-account deficit estimated at $2.8 billion in 1981, up from $2.0 billion in 1980. Although a significant part of that increase reflected a rise in oil inventories likely to be reversed this year, the 1982 current-account shortfall could well be even larger.

Modest recovery seen for Spain's economy, but unemployment will continue rising.

The Spanish economy remains depressed, and the unemployment level continues to climb. There is, however, some indication that the bottom of the recession has been reached and that a modest upturn may have commenced in the second half of 1981. Exports of goods and tourism have recovered despite still-deteriorating Spanish competitiveness within Europe. Also, public-sector investment has been strong, as it is an integral part of the government's stimulatory fiscal package. The current year is expected to see some further improvement, largely on the heels of the recovery anticipated for the rest of Europe. It is also expected that wage and price inflation will moderate and that Spain's current-account deficit will narrow slightly to about $4.5 billion. Nonetheless, such a performance is unlikely to be sufficient to prevent unemployment from reaching the 2-million mark, or 18% of the labor force.

Japanese measures to spur imports will not prevent trade surplus growth.

With an overall trade surplus of about $21 billion, as well as large bilateral trade surpluses with the United States and the European Community last year, Japan is under intense pressure to restrain its exports and boost imports. Last December, the Bank of Japan cut its discount rate 75 basis points to spur domestic economic activity and, consequently, import demand. In addition, the government has announced a variety of import-related measures. It will extend $500 million in foreign-currency loans to finance special import purchases; authorize the emergency import of rare metals, together with the stockpiling of an additional 9.4 million barrels of oil; review quotas and other restrictions on such imports as oranges and beef; and ease product-testing procedures. The government is also accelerating by two years the stage-by-stage reduction of tariffs agreed upon in the Tokyo Round, implementing the scheduled cuts for fiscal 1982 through 1984 at one stroke in April 1982. Despite these measures, however, import growth is expected to remain modest in 1982 so that even with an export slowdown, Japan's trade surplus is expected to expand.

Brazil hoping for sustained external-payments improvement.

The Brazilian government is hoping to see the improvement in its balance of payments in 1981 carry through to 1982. The merchandise trade accounts last year shifted into a substantial $1.2-billion surplus from a $2.8-billion deficit in the previous year. As a result, the current-account deficit narrowed to $10.6 billion from almost $13 billion in 1980. The government sees export strength as the key to further improvement, since the import decline of last year is not likely to be repeated as economic growth accelerates. Priorities are being placed on industrial and agricultural exports in order to produce a trade surplus in the $3-4-billion range. If interest costs do not accelerate—a possibility in view of declining world interest rates—Brazil could post a further decline in its current-account deficit to $10 billion or less. Attainment of a smaller deficit, in turn, would reduce further Brazil's borrowing needs in 1982-83.

Iranian export earnings rebounding.

Iran's financial position deteriorated steadily over the course of 1981. While the war with Iraq contributed to the worsening, it was more the result of weak demand for Iranian oil, which until November was priced at $5 per barrel above Saudi marker crude. Prior to the November OPEC price realignment, exports had fallen to as low as 450,000 barrels per day, although revenue needs required a level of about 1.3 million barrels daily. Foreign-exchange reserves had fallen below $3 billion, and measures were taken to limit imports. In November, Iranian oil prices were reduced by $2.40 per barrel, and the differential with Saudi marker crude fell to only $0.60. Buyers have consequently returned, and latest reports indicate oil exports in the range of 900,000 barrels daily. Although this will not be sufficient to finance all of Iran's desired imports, it represents a substantial improvement in the country's financial position.

Surprise Money Surge Shifts Expectations

The recent surge in money growth caught the financial markets by surprise. While most forecasters had expected money growth to be relatively moderate in November and December, M1 (formerly M1-B) expanded at a seasonally adjusted annual rate of 12%. This unexpectedly rapid growth has been a major force behind the recent rise in interest rates.

Forecasters have been hard-pressed to explain the recent behavior of the money stock. It had been thought that the apparently steep decline in economic activity in the last two months, combined with a decline in the inflation rate, would keep money growth relatively weak by depressing the transactions demand for money. To be sure, it was anticipated that this effect might be offset somewhat by the easing in Federal Reserve policy and the concomitant sharp decline in interest rates that occurred in the fall. Such rate declines generally increase the demand for money relative to other assets. It is highly unlikely, however, that such a "rate effect" can explain the rapid growth of money in recent months.

While the money surge may be difficult to explain, its effect on interest rates is clear. Since late November, the rate on 90-day large, negotiable bank certificates of deposit has risen about 200 basis points and the yield on 30-year Treasury bonds has risen over 150 basis points.

To a large extent, these rate responses reflect changes in expectations regarding the effect of Federal Reserve policy on money-market rates. Specifically, since money growth has recently exceeded both expectations and the probable short-run targets of the Fed, the probability has increased that Federal Reserve open market tactics will put upward pressure on the federal funds rate.

A further expectational element may also be at work, however. This element concerns the information that recent rapid money growth may be conveying about the current or near-term future course of the economy and total spending. Monetary data are more timely than data on the performance of the economy, and are sometimes considered an indicator of total spending. Thus, the unexpected surge in money growth may suggest that total spending is either not as weak—or will not be as weak in coming months—as most forecasters had previously anticipated. This in turn would imply that expectations of future private credit demands and inflation may have increased.

Of course, the reliability of money growth as an indicator of total spending, especially in the short run, is distressingly poor. Nonetheless, the possibility—however slight—that recent money growth does imply greater strength in total spending has reinforced expectations of a near-term rise in interest rates.

Prospects Dim for Housing Recovery

The housing sector has perhaps borne the worst brunt of the restrictive Federal Reserve policy of the last two years. New housing units are currently being started at a rate 50% less than in the summer of 1979, and resale activity of older houses is down also by about 50%.

The apparent severity of housing's current problems is partly the result of comparison with the housing sector's boom years in the late 1970s. During 1966-75, an average of 1.6 million housing units per year were built, and turnover of existing homes averaged two million per year. In contrast, an average of 1.7 million units per year were built during 1976-80, with resales averaging 3.4 million.

Price behavior between these two time periods was also quite different. Housing prices rose by an average of about 6% during 1966-75, only slightly faster than the 5½% average rate of increase in the Consumer Price Index. But as inflation accelerated to nearly 9% in the latter half of the 1970s, heightening the investment and tax-saving benefits of home ownership, housing prices spurted by an average of 12% per year —three percentage points higher than inflation.

This rush into housing as an investment vehicle at a time when many other investments were failing to keep pace with inflation was aided by easier financing. Mortgage interest rates averaged only one percentage point above the rate of inflation during 1976-80, compared with two percentage points in the earlier period. And there was a marked trend over the fifteen-year period toward easier terms, i.e., longer-maturity mortgages and smaller down payments.

These trends began to reverse in 1980, with the reversal accelerating in 1981. The mortgage rate averaged about 14.75% in 1981, while the CPI rose only 10%; terms also tightened, especially with the shift toward shorter mortgages. Consequently, house prices increased by 6% last year, much less than the CPI; new housing construction barely topped one million units; and sales of existing homes totaled only a little over 2¼ million. Furthermore, activity slowed dramatically in the South and West, regions that had previously been less vulnerable.

As 1981 drew to a close, however, the rate of decline in housing activity slowed even as mortgage rates continued to rise. In December, mortgage rates actually declined somewhat, giving rise to hopes that a recovery would soon be under way. Any significant housing recovery, however, will depend upon sustained decreases in interest rates, since in a period of softening prices, lenders' other terms can be expected to remain restrictive. But as long as Federal Reserve policy continues explicitly disinflationary—resulting in interest rates several percentage points above the inflation rate—a return to upward spiraling house prices is remote.

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS 6 months ending	EXPORTS change from year earlier	GNP IN 1980 in billions of dollars	GNP IN 1980 per capita	BALANCE OF PAYMENTS latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	MONEY AND BANKING 12-month changes latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars January 13, 1982	change from year earlier	current monetary conditions	COUNTRIES
Africa	Algeria	Public-sector investment target for 1982 is $22 billion, up 35% from 1981.	Oct.	— 21%	29.0*	1,525	Nov.	3,839	+ 6%	4.7	0	Agreement reached with France on LNG export price.	Dec. '79	+12%	July	+17%	.2320	— 9%	European investment Bank may lend $55 million.	Algeria
	Egypt	New government reassessing economy prior to setting development goals.	June	+ 30%	22.7	535	Sept.	1,171	+ 5%	2.4	102	Suez Canal tolls up 5%; oil find in Suez Gulf proves commercial.	May	+10%	Sept.	+11%	1.23	14%	Money supply expanding steadily.	Egypt
	Ivory Coast	World Bank approves $150-million structural adjustment loan to revitalize economy.	Apr.	+ 1%	10.5	1,312	Sept.	8	—59%	0.1	325	Five Espoir field exploratory wells yield mainly gas, rather than oil.	May	+11%	Apr.	+ 4%	.003436	—16%	Liquidity shortage persists.	Ivory Coast
	Kenya	Producer prices raised for maize and wheat.	June	— 12%	6.8	414	Nov.	264	—47%	1.5	207	September devaluation curbing import growth.	Sept.	+12%	July	— 1%	.1110	—21%	Monetary policy continues highly restrictive.	Kenya
	Madagascar	Joint ventures with Libya to be set up in agriculture, livestock, fishing, and shipping.	Dec.	+ 5%	3.0	345	Dec.	0	---	0	88	French credits of $73 million will finance badly needed imports.	May	+39%	n. a.	—	.003506	—14%	Malagasy banks out of foreign exchange.	Madagascar
	Malawi	Export-led recovery estimated to have lifted 1981 real GDP growth to 4.8%.	Aug.	+ 17%	1.5	250	Nov.	69	—12%	2.6	89	High tobacco prices boost export receipts and close trade gap.	Aug.	+ 7%	Oct.	+11%	1.1150	— 6%	Credit to government expands sharply.	Malawi
	Morocco	Economy adversely affected by second consecutive year of drought.	July	— 9%	18.1	896	Oct.	182	—11%	0.5	458	Current-account gap estimated at $1.8 billion in 1981, vs. $1.4 billion in 1980.	Aug.	+15%	Aug.	+10%	.1900	—21%	State phosphate company raises $175-million Eurocredit.	Morocco
	Nigeria	Reduced allocations to states cause cuts in project outlays.	Oct.	— 45%	78.0	1,013	Oct.	5,217	—49%	3.3	0	Oil price cuts of $0.30-$1.45 per barrel effective January 1.	Dec. '80	+14%	Apr.	+29%	1.5755	—18%	Seven new banks to be run by state governments.	Nigeria
	Senegal	Construction begun on $300-million phosphatic fertilizer project.	Dec.	— 9%	2.5	437	Sept.	4	—62%	0	142	Forecast doubling of groundnut crop should bolster 1982 payments balance.	Aug.	+ 8%	Mar.	— 2%	.003436	—23%	Liquidity tightness continues.	Senegal
	South Africa	Hike in general sales tax or reimposition of loan levy expected in March budget.	Oct.	— 22%	76.9	2,627	Nov.	677	—33%	0.4	0	Premiums on forward dollars discourage offshore trade financing.	Oct.	+15%	July	+37%	1.0370	—21%	Further monetary tightening probable.	South Africa
	Sudan	Devaluation and other incentives should spur cotton production.	July	+ 32%	9.0	482	Nov.	31	—63%	0.2	480	Current account gaps in '81 and '82 near $800 mn., requiring external aid.	May	+27%	Sept.	+41%	1.1275	—44%	Inflationary pressures increase.	Sudan
	Tunisia	Public-sector capital budget for 1982 is $1.3 billion, 16% larger than last year.	Sept.	0	8.6	1,350	Nov.	661	— 4%	1.9	0	Two significant oil discoveries made recently.	Sept.	+10%	Aug.	+24%	2.02	—18%	Local banks expected to finance more investment.	Tunisia
	Zimbabwe	Wage hikes and temporary price freezes squeeze many businesses.	Dec.	— 5%	4.8	645	Aug.	220	—30%	1.7	86	Reopened Beira-Umtali pipeline ends need of S. Africa for fuel transport.	Dec.	+20%	Dec.	+16%	1.45	0	Liquidity severely tightened.	Zimbabwe
Middle East	Jordan	Record government 1982 budget of $2.2 billion approved, up 16.6% from last year.	Feb.	+148%	3.6	1,127	Nov.	1,166	—10%	6.1	0	Phosphate export revenues holding steady.	Sept.	+19%	Aug.	+27%	3.00	— 4%	Saudi Development Fund to lend $47 million.	Jordan
	Kuwait	Kuwait Petroleum Company to step up overseas oil exploration activity.	Oct.	— 9%	27.3	19,870	Nov.	3,732†	— 6%	7.0	0	Project awarded to Japanese firm to tap neutral zone gas now flared.	Dec. '80	+ 8%	Sept.	+28%	3.5350	— 4%	Indian firm makes record $107-mn. private bond placement.	Kuwait
	Qatar	Budget expenditure target for 1982 cut nearly 7% from 1981 allocation of $2.5 billion.	Oct.	— 9%	5.0	23,100	Sept.	347†	—10%	3.2	0	Oil price cut $0.20 per barrel to $35.30-$35.45.	n. a.	—	Sept.	+17%	.2775	+ 1%	Bank claims on private sector growing rapidly.	Qatar
	Saudi Arabia	Actual government spending in fiscal 1980-81 was $62 billion, up 13% from year earlier.	Oct.	+ 15%	117.6	19,500	Nov.	31,549†	+28%	12.4	0	Oil production ceiling cut to 8.5 million barrels per day.	June	+ 2%	July	+17%	.2935	— 2%	Money supply growing steadily.	Saudi Arabia
	United Arab Emirates	Abu Dhabi plans increase in oil output capacity to 3 million barrels daily by 1985.	Oct.	— 3%	19.4	23,000	Nov.	3,094†	+59%	4.3	0	UAE oil output was 1.4 million bpd in 1981, down 15% from 1980.	n. a.	—	Sept.	+ 8%	.2750	+ 1%	Credit to private sector continues to increase.	United Arab Emirates

*1979 †Excluding state reserves

World Interest Rates

market rates of Jan. 13, 1982; bond yields as of Jan. 8, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	14.74	14.406 intervention rate	14.00	9.00	7.50	19.00 penalty rate 22.00	9.00	6.00	5.50
Day-to-Day Money	12.75 January 14	14.25	14.75*	11.95	15.50	10.20	20.375	10.25	5.125	6.5625
Treasury Bills 91-day, Middle Rates	12.08 discount basis	14.45	14.625*	15.00	16.18 one year	n.a.	19.401 90-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	12.00 finance paper discount basis	15.20 finance paper 15% tax w/h	13.794*	13.90 Certified	15.375 interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	12.70	15.05 15% tax w/h	14.75*	13.90 Certified	not traded	9.90	23.70	no market	9.125	no market
Government Bonds Long-term, new and old issues, average yield	14.61	16.812	15.37	11.46 20% tax w/h	15.99	9.78	21.01	11.22	5.35	7.462
Industrial Bonds prime, long-term, new and old issues, average yield	15.60 Aa Industrials	16.32	16.61	16.425	17.31	9.95	20.78	12.49	6.3125	7.15
Bank Short-Term Rate to Best Borrowers (prime rate)	15.75	16.50	15.50*	17.50	16.85	15.50	22.50 ½ quar'ly fee on outstdng.	12.50	9.75	6.00
Bank Time Deposits 3-month	12.75 Cert. of Dep.	15.00	15.50*	14.75	15.375	10.35	10.75	10.875 large deposits	8.00 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	14.3125	no market	15.5625	no market	16.75	10.50	no market	10.875	8.8125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8392	1.8675	.0257	.1712	.4345	.000813	.3986	.5365	.00446
Forward Exchange Cover 3 month, in percent p.a. *D* = discount, *P* = premium	—	1.20 *D*	1.075 *D*	6.586 *D*	2.316 *D*	3.648 *P*	7.824 *D*	3.298 *P*	5.322 *P*	7.854 *P*

Eurodollar Deposits
(London, interbank, bid)
January 14

7-day	13.0625
1-month	13.5625
3-month	14.125
6-month	14.9375

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	n.a.
U.S.-Canada Treasury Bills	− .478
U.S.-Canada Finance Co. Paper	−1.791
Eurodollars-U.K. Local Auth. Deposits	n.a.

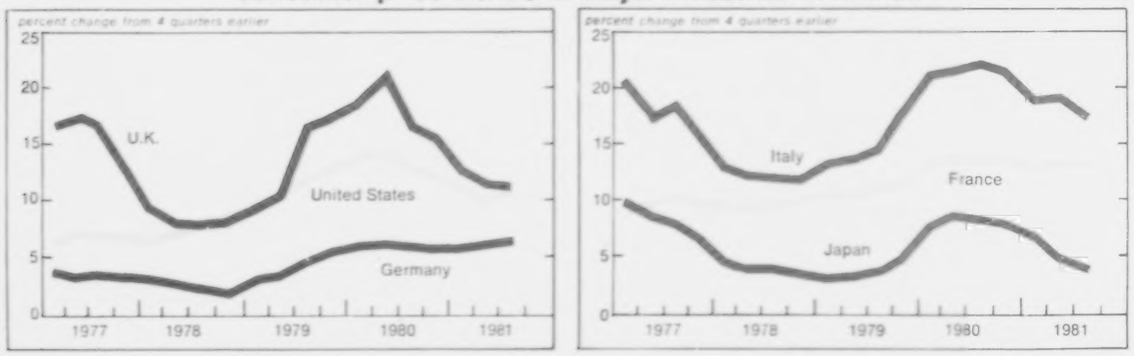
Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.75
Over 7 yrs.	16.00
DM Bonds	
7 yrs. and under	9.75
Over 7 yrs.	9.75

Gold Price
London afternoon fixing
380.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Market rates as of Jan. 6, 1982.

Consumer price trends in major industrial countries



Chinese Readjustment to Continue

After two years of stabilization policies and tentative economic reforms that reduced national income growth to an average 6% in 1979-80 from over 12% in 1978, China's budgetary authorities proceeded to adopt highly restrictive policies at the start of 1981. And Chinese policymakers have recently ratified a plan that will maintain the austere stance of fiscal and monetary policy in 1982.

The impact of the austerity measures in 1981 was most dramatic in heavy industry and capital construction, where annual production fell below 1980 levels. Indeed, midway in 1981, heavy industrial output was nearly 10% below the year-earlier period; a modest recovery in the second half moderated the fall, bringing annual production to about 4½% below 1980.

The decline in China's heavy industry last year was concentrated in marginal enterprises, particularly the smaller coal mines and metallurgical plants. Given their antiquated technologies, these plants have long operated at economic losses simply to boost gross output figures and employment. And because of China's irrational price structure, the extent of such operating subsidies was often unknown by central planners.

Spending on capital construction in 1981 fell to 25% below that of 1980 as construction organizations were directed to complete unfinished projects rather than begin new ones. One of the major objectives of the austerity program has been to establish greater control over construction authorized by provinces and municipalities. Even though progress was made, total investment in capital construction will probably exceed 40 billion yuan[1] in 1981. One major construction project that may win approval in 1982 is a nuclear power plant. It would be China's first, and would be located in Guangdong Province near Hong Kong, where projected electricity demands are expected to far outstrip generation capacity.

The shift of resources away from heavy industry did contribute to bottlenecks for certain key materials as well as budgetary hardships in some regions last year. Still, the growth of light industry and agriculture remained strong and more than offset the declines in other sectors. Indeed, output of light industry and textiles rose 14% in 1981, after an increase of 18% in 1980. This sustained 9% growth in the volume of retail sales of consumer goods and 10% growth in exports measured in current dollars.

Despite problems with flooding and drought in the early summer of 1981, total grain production for the year is estimated at 325-330 million metric tons—only slightly below the 1979 record harvest. Estimates of total agricultural production show a 2½% rise above the 1980 level, with cotton, sugar, and oil seeds posting the strongest gains. Growth in the livestock sector, however, slowed from the rapid pace achieved in 1979-80. All in all, national income growth last year is estimated at just 3%.

Inflation and government spending

Various austerity measures to limit wage increases, maintain state employment levels, and reduce public spending helped ease domestic inflationary pressures last year. Significantly, the state budget deficit was cut to 2.7 billion yuan, equal to only one-fifth the 1980 deficit.

State Budget (billion yuan)	1979	1980	1981 prelim.	1982 proj.
Total Revenue	110.3	108.52	105.86	110
Total Expenditure	127.3	121.27	108.58	113
Balance	−17.0	−12.75	−2.72	−3

The most rapidly growing component of government expenditure has been outlays for consumer subsidies, which rose 50% in 1981 to 32 billion yuan. Prices for tobacco and liquor were raised nearly 40% at the end of 1981 to offset partially these subsidies paid for grains, cooking oil, meat, dairy products, and vegetables—which primarily benefited urban consumers.

Actual inflation rates in China are difficult to estimate, but the official data will probably show an increase in retail prices of only 3%-4% in 1981, an improvement over the 6% rate recorded in both 1979 and 1980. Part of this improvement can be traced to official efforts to contain monetary growth. To help absorb excess money balances, the government sold 4.67 billion yuan in treasury bonds (paying 4% interest over 10 years) in the first half of the year. And after explosive growth of some 25% annually during 1979-80, the money supply actually declined in 1981 by 5%-10%.

Impact on external position

The direction of the effect such domestic austerity will have on China's foreign trade is clear, but the extent of the shift toward balance remains uncertain. In the first half of 1981, China's imports grew more rapidly than its exports. Data through September released by the Ministry of Foreign Trade indicate, however, that imports fell sharply in the summer and that China recorded a trade surplus of $1 billion in the third quarter.

Imports of machinery were down significantly in the first nine months of 1981, but they are likely to increase once again in the wake of agreements signed with Japan. Grain imports were high in the first half of the year, but dropped off significantly in the second

[1] *1.71 yuan = U.S. $1, estimated average exchange rate for 1981.*

Chinese Readjustment to Continue *(continued from page 7)*

half. China has signed several bilateral agreements to cover annual imports of 12-17 million metric tons of grains to supply coastal regions. Japanese steel shipments are also expected to increase this winter, particularly with construction work planned for transporting coal to Beijing and northern ports. Taking into account all of these influences, China's trade deficit with the member nations of the International Monetary Fund is estimated to have been $1.0-1.5 billion in 1981, compared with a $2.2-billion deficit in 1980.

At the end of 1981, Finance Minister Wang Bingquian estimated that China's external liabilities had reached $4.7 billion, up from $3.4 billion at end-1980. (This figure probably does not include liabilities in certain joint ventures and provincial compensation agreements.) During the year, China received its first World Bank loan of $200 million for educational projects, and several other major project loans are anticipated for early 1982. China will probably draw another 450-million SDR tranche from the IMF in 1982, which will boost its total drawings from multilateral sources to $1.5 billion. As of mid-1981, China's foreign-exchange reserves had risen to $3.[illegible] billion (a surge of $1.5 billion in six months). Reserves were unchanged at the end of the third quarter despite the large trade surplus; they are expected to have declined to around $3 billion by yearend as various commercial loans drawn in the fourth quarter of 1980 were repaid.

China's other major source of foreign capital has been Japan. A 300-billion-yen loan has been negotiated to help finance the completion of the Baoshan steel complex and two petrochemical projects at Daqing and Nanjing that had been cancelled a year ago. Japan has also been providing annual loans of 50-60 billion yen for infrastructure development in China, and more than 200 billion yen has been granted for offshore oil exploration and development in the Bohai Gulf. Additionally, the Export-Import Bank of the United States has approved two major loans covering purchases from Westinghouse and Combustion Engineering. The total of U.S. official credits, however, still remains at less than $100 million.

Policy responses

During the past year, spokesmen for economic development and new projects have begun to stress the need for a new five-year plan and a shift of resources back to heavy industry and construction. The revival of the Japanese projects even prompted some Western observers to predict a major swing in economic policy back toward rapid growth. Instead, the National People's Congress has ratified a plan and budget for 1982 that will maintain fiscal and monetary austerity. Premier Zhao indicated that readjustment will continue for several more years while announcing that the five-year plan for 1981-85 is still being drafted. At the same time, he emphasized the importance of foreign trade for China's modernization, and supported the outflow of Chinese labor for construction projects abroad as well as the inflow of Western capital and technology.

The meeting of the National People's Congress in late 1981 produced a new tax law governing foreign operations in China. The law provides for a progressive rate structure ranging from 20%-40%, with a local surtax of 10%. It should preclude the incidence of double taxation for Western companies. However, the financial incentives given under the law are less generous than those provided multinational enterprises in other Asian countries. This may actually slow the growth of direct investment in China—with the significant exception of offshore oil development, which may require $5-10 billion of foreign capital before 1990.

Continuing the trend of recent years, China moved at the end of 1981 to reorganize and upgrade its banking system. The People's Bank announced an increase in interest rates paid to depositors and charged to borrowers. For transactions with maturities between one and five years, interest rates will range from 6.48% to 8.28% for overseas depositors and from 5.76% to 7.92% for domestic depositors. At the same time, the Ministry of Finance authorized the establishment of a new investment bank to raise foreign loans for joint ventures in China. This specialized institution will be controlled by the Ministry of Finance and the Bank of China, but will probably consist merely of a consolidation of existing offices that will remain within their old bureaucracies.

Outlook for 1982

The outlook, then, is for China's economic growth to remain modest in 1982, with national income growing at approximately the planned rate of 4%. Some recovery in heavy industrial production and capital investment is anticipated. Domestic investment will continue to emphasize infrastructure, drawing upon financing and expertise provided by the World Bank and foreign governments. And on the external front, China is expected to post a hard-currency trade deficit of approximately $2 billion.

China's new tax legislation should help stimulate offshore oil development in several promising areas. Given the magnitude of offshore petroleum investments and the delays anticipated in development, however, international oil companies and banks will be carefully assessing the political risks involved in direct investment. Still, the long-term outlook for China appears promising, particularly when contrasted with the slow growth seen for the other centrally planned economies in the 1980s.

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Unexpected Money Growth Prompts Dollar Strength

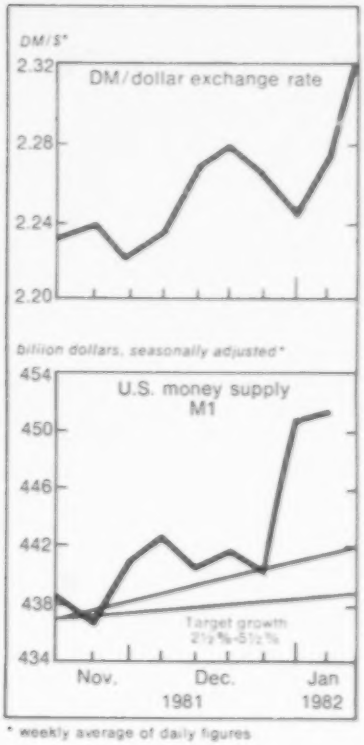
The foreign-exchange value of the dollar has risen sharply in recent weeks, in spite of the current weakness in the U.S. economy. The primary force behind this excess demand for dollars has been expectations. The unexpectedly rapid growth of the money supply (as measured by M1) has resulted in an increase in the market's perception of the likelihood that the Federal Reserve will tighten monetary policy.

This acceleration of the money supply was not fully anticipated by the market because monetary strength is unusual for an economy in a period of steep decline. Growth in the demand for M1 arises principally from growth in transactions demand, and transactions ease off, not accelerate, during recessionary periods. Further confounding the markets—and creating substantial uncertainty until these "mixed signals" are resolved—are the informational lags associated with data on real economic activity versus data on the money supply. However, since data on the real sector are reported with lags of up to two-to-three months, while monetary data are reported with lags of only two weeks, a critical question arises: Do the monetary data reflect a much quicker than expected turnaround in the U.S. real economy, or are they merely aberrations that will be reversed in the weeks ahead? The resolution of this issue poses opposite paths for the dollar's value.

If the rapid growth of the money supply represents incipient real economic strength, the foreign-exchange market expectations will be confirmed. The necessary tightening by the Fed to constrain money growth to within target limits may be severe, leading to significant excess dollar demand and dollar strength over the near term. Alternatively, if the recent growth in the money supply is merely due to temporary factors, and is reversed in the weeks ahead, then the dollar will weaken. Confirmation that real economic activity in the United States is continuing to decline would shift market perceptions from anticipated excess demand for dollars to an anticipated excess supply.

Thus, the quandary existing in foreign-exchange markets is similar to that facing U.S. domestic financial markets. The signals as to the near-term course of the real economy are not fully consistent, and the likely policy actions of the Fed in the short-run are still highly uncertain. The suspicion here is that the recent monetary growth has misled the market, and the current dollar strength will prove temporary. But when the turn-around will come is highly uncertain.

U.S. money growth and exchange rates



* weekly average of daily figures

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Germany's continued domestic weakness prompts lowering of Lombard rate.

Germany's economy is currently being sustained by exports, which rose at an annual rate of 24% in the third quarter. Domestic demand, however, remains depressed, with domestic order volume falling by some 6% since the beginning of 1981. The unemployment rate soared to 7.3% in December, from 4.8% at the end of 1980. This weakness in the domestic economy coincided with below-target growth in Germany's central bank money stock (CBM) and prompted the Bundesbank to reduce its special Lombard rate by one-half percentage point to 10%, despite a firming of U.S. interest rates. The Bundesbank's slight easing was taken in conjunction with similar moves in Britain and Holland. It may indicate that Europe's recession has reached a point where central banks are putting less emphasis on defending their currencies against a strong dollar, particularly if they perceive the firming of U.S. money market rates to be temporary.

Danish economy poised for recovery: policies likely to remain restrictive.

The Danish economy now seems to have weathered the worst of its problems and looks set to begin a long road to recovery. The new government, elected at the end of last year, is expected to continue with reasonably restrictive economic policies. And assuming that economic activity in most of Europe will generally perk up this year, current forecasts are projecting a modest 2% real growth for Denmark in 1982. The rate of inflation—which at 11% in 1981 was the highest in the European Monetary System—is expected to decelerate somewhat this year to around 9%. And a narrowing of the current-account balance-of-payments deficit also seems likely. According to budget plans announced earlier this month, however, there seems to be little scope for any reduction of the huge government deficit. The fiscal 1982 budget gap is now forecast at kr. 47.7 billion, which it is estimated would amount to some 10% of GNP—even higher than the 1981 deficit, which came to about 9.5% of GNP.

Chilean inflation dramatically lower as recession takes hold.

Weak international metal prices, the economic slowdown in the industrial countries, and a fixed exchange-rate policy for two-and-a-half years have combined to cloud Chile's economic prospects in the near future. Economic activity is slowing rapidly; real GDP is estimated to have risen approximately 5% in 1981, versus annual increases averaging 7% in the previous two years, and no growth is expected for 1982. In the external area, the current-account deficit has expanded to an estimated $4.3 billion in 1981 from $1.8 billion in 1980. But even without an exchange-rate adjustment, the current-account gap is not expected to widen much further in 1982. This is because copper prices are likely to rise moderately and import growth should begin to ease off, reflecting the recessionary economy. One bright consolation to the slackening is that inflation has dropped precipitously from 31% at the end of 1980 to 9% by end-1981. And if no exchange-rate correction is made, inflation can be expected to fall even lower in 1982.

Venezuela postpones stimulative policies in light of sluggish oil markets.

The reactivation of the Venezuelan economy that had been expected in 1981 did not occur, and the economy remained stagnant for the third consecutive year. Government authorities—not wanting to fuel aggregate demand at a time when the world oil market was experiencing a reversal—maintained a restrictive posture toward fiscal and monetary policy. Agricultural production suffered a setback because of adverse weather conditions in the early part of the year. In addition, Venezuela, along with several other OPEC members, reduced crude oil production by some 10% at midyear in an effort to firm oil prices. Venezuela's external sector continued to perform well, however, despite the moderation of oil prices and a drop in the volume of oil exports. The current-account surplus is estimated to have fallen only to about $3 billion in 1981 from $4.2 billion in 1980. The government's conservative demand-management policies and a hiatus in its price liberalization program did have a positive impact on inflation. With the help of lower import costs, owing to dollar strength in the first eight months of the year, the rate of inflation was held at 12% in 1981, according to official statistics—a significant improvement over price increases of 20% in both 1979 and 1980.

Year of economic adjustment ahead for Finland under new president.

Finnish economic statistics are converging towards the European average after three years in which the country consistently outperformed the rest of Europe. Real growth is expected to slow to some 1.8% this year. And the inflation rate is expected to slow to near 10%. The current-account balance-of-payments deficit is likely to widen to about $1 billion. The Finnish government, under its newly-elected President Koivisto, will clearly seek to use 1982 as a year of adjustment. With inflation falling and some degree of surplus industrial capacity, the country should be able to take advantage of an economic strengthening in Europe and move back to a higher growth path by 1983.

Signs emerge of shift in Korean policy, but constraints are strong.

South Korea's recent cabinet reshuffling may signal subtle changes in the country's economic policies. With real growth estimated at 7% in 1981, the economy did recover from the severe recession of 1980. However, the current-account deficit remains onerous—$4.7 billion last year—and although the inflation rate was reduced to about 13% last year from 28% in 1980, there is the danger of a reacceleration in inflation. Given the overriding concern about improving the balance of payments and price stability, the policy options of the new economic team are limited. A shift toward encouraging the private sector, however, may be in the offing. The new cabinet has lifted direct controls on bank credits, and appears ready to accept a gradual but realistic adjustment of the won's exchange rate. Interest rates have also been lowered. And measures have been taken to increase low-cost export financing and to provide a fiscal stimulus to housing. While these are not all necessarily "free-market" oriented, they reflect the government's desire to bolster business confidence, which was shattered in part by the failed industry-realignment effort early in the Chun regime.

Pakistan de-links rupee from dollar to enhance export competitiveness.

As another indication of its resolve to turn the economy around, the government of Pakistan announced on January 7 that the rupee would no longer be pegged to the dollar. Instead, the rupee's value would be linked to a trade-weighted basket of currencies of Pakistan's major trading partners. The rupee had been fixed at a rate of 9.9 rupees per dollar since 1973. However, with the rupee pegged to the dollar, the strong appreciation of the dollar during 1981 resulted in a serious loss of competitivenesss in Pakistani products. Pakistan's exports suffered as a result, increasing only 11.5% in July and August from the level a year earlier, compared with export growth of 16.3% for a comparable period in 1980. By adopting a basket policy, Pakistan's monetary officials will be able to insulate the value of the rupee from further sharp changes in the dollar's value. The dollar will still remain the intervention currency, but the central bank will set the rupee/dollar rate daily to achieve a desired behavior of the rupee against the basket, given the dollar's performance against other currencies.

Drought again threatening Moroccan grain harvest.

Morocco's current-account gap widened noticeably last year to $1.75 billion from $1.42 billion in 1980, according to preliminary estimates. The deterioration stemmed largely from a jump in the merchandise trade deficit to over $2 billion from $1.8 billion in the previous year. Imports, led by purchases of petroleum and foodstuffs, rose to $4.2 billion (on a c.i.f. basis). The increased food imports reflected not only larger purchases of grains—whose domestic output was cut 50% by the 1980-81 drought—but also the higher local currency costs of imports resulting from last year's 31% depreciation of the Moroccan dirham against the dollar. Dollar-denominated export revenues fell slightly, despite a sharp increase in receipts from phosphate exports. The trade deficit would have been even larger had it not been for continued growth in exports of "invisibles"—primarily worker's remittances and tourist income. The outlook for 1982 includes the risk of another sizable trade deficit. While major exports of goods and services are expected to expand, dry weather is once again threatening the Moroccan grain crop, raising the prospect of a second year of huge food imports.

Optimism on the Inflation Front

The rate of inflation moved back down into single digits in 1981. For the year, the Consumer Price Index (CPI) slowed to under 9%—down significantly from more than 12% in 1980 and over 13% in 1979. The outlook for 1982 suggests continued progress, with the CPI forecast to rise less than 7%. And prospects for 1983 are possibly even better.

The recent improvement in inflation, as well as increased optimism about the future, has come about largely because of a reversal in the forces underlying the double-digit inflation rates of 1979 and 1980. Excessive fiscal and monetary stimulus in earlier years exerted much of the upward price pressure. And the second oil price shock—touched off by the Iranian Revolution in 1979—combined with the dollar's rapid decline on the foreign-exchange markets in the late 1970s, added further to the inflationary stress.

Generally more restrictive Federal Reserve policy over the past two years has laid the groundwork for a sustained deceleration of inflation in 1982. The change in the Fed's operating strategy in October 1979 resulted in lower average growth in the money supply. Growth in M1 (formerly M1-B) slowed from 7½% in 1979 to 6½% in 1980 and 5% in 1981. In addition, the rate of increase of federal expenditures is now decelerating markedly. World oil prices have been relatively stable and are likely to remain so for at least this year. Weak domestic demand has held down the prices of final petroleum products even more. Furthermore, the foreign-exchange value of the dollar has strengthened significantly.

Perhaps most important to future price prospects, however, is that falling actual inflation is helping to lower expectations about future inflation. Although the skepticism of many financial-market participants about the Fed's ability to adhere to its policy of lowering money growth is currently keeping real interest rates high, other market participants are adjusting their expectations more quickly. Farmers and other commodity producers, for example, are being forced to accept outright price declines because of weak final demand and high real carrying costs.

And in the labor market, evidence of a willingness to accept smaller wage increases—particularly in the non-unionized sectors—is becoming more prevalent. The hourly earnings index grew at an annual rate of about 8% in December, down from 10% in early 1981. Moreover, the fact that some of the large unions are bargaining this year in an environment of slowing inflation and high—if not rising—unemployment would suggest that average wage gains may narrow even more. This should ease unemployment, and give the Fed a bit of political breathing room, improving the likelihood of its staying with a disinflationary policy.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1980		BALAN			
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered li
Austria	Selective reflationary measures are now under discussion as growth prospects weaken.	Mar.	+1%	76.5	+3.1%	Nov.	4,590	— 5%	2.7
Belgium	New government obtains special powers to deal with growing fiscal deficit and wage indexation.	Oct.	−1%	118.7	+2.0%	Nov.	5,306	−34%	1.0
Britain	Economic upturn at end of 1981; output growth forecast in 1982, after two years of decline.	Nov.	+1%	524.6	−1.4%	Nov.	15,570	−27%	2.0
Denmark	Revival of economy expected over the course of 1982.	Oct.	−8%	64.7	−0.2%	Nov.	2,678	−18%	2.0
Finland	Economic growth continues to slow.	Oct.	+3%	51.0	+6.0%	Nov.	1,390	−27%	1.2
France	Despite strong consumer goods sector, intermediate and capital goods sectors remain flat.	Oct.	−2%	651.1	+1.2%	Nov.	21,837	−24%	2.3
Germany	Economy remains weak; limited fiscal reflation under consideration.	Nov.	0	822.2	+1.8%	Nov.	44,582	— 7%	3.4
Greece	Reflationary budget expected in February as economy continues in recession.	n. a.	—	61.1	−0.7%	Nov.	1,352	+17%	1.9
Ireland	Strongly restrictive budget is expected at end of January.	Aug.	+1%	17.6	+1.9%	Nov.	2,702	+ 7%	3.1
Italy	Domestic economy remains weak but inflation moderates; 1% real growth expected in 1982.	Nov.	0	394.9	+4.0%	Nov.	18,559	−19%	2.4
Netherlands	Special employment-creating program instituted, but authorities impose another year of incomes policy.	Oct.	0	159.9	+1.0%	Nov.	9,259	−19%	1.7
Norway	Economic activity apparently picking up slowly.	Oct.	−3%	55.4	+3.6%	Nov.	6,463	+ 5%	5.3
Portugal	Economic growth in 1981 unlikely to have reached official target of 2.9%	Mar.	−2%	23.5	+5.5%	Oct.	616	−44%	0.8
Spain	Hopes of export-led recovery emerging.	Dec. '80	+5%	195.9	+1.5%	Oct.	11,360	— 8%	4.3
Sweden	GDP is expected to show almost no growth in 1982, following 1.2% decline last year.	Sept.	−6%	121.6	+1.4%	Nov.	3,578	+ 3%	1.6
Switzerland	Business outlook deteriorating; real GDP decline likely in 1982.	June	0	105.8	+3.9%	Nov.	10,429	−18%	4.1
Canada	Economy slowing down, with higher unemployment and weaker industrial activity.	Oct.	−2%	247.9	0	Nov.	3,702	+46%	0.6
United States	Inventory liquidation leads to continued cutbacks in production.	Dec.	−5%	2,626.1	−0.2%	Nov.	19,850	+37%	0.9

Business Credit Demand to Stay Strong

Sharp cutbacks of business inventories are accompanying the continued weakness in the economy. As a result, many observers anticipate that bank loan growth will slacken, taking some pressure off short-term interest rates. Recent evidence, however, seems to conflict with this view.

Over the fourth quarter of last year, for instance, total business loans rose at a 13% annual rate. And the usual January correction, offsetting loans made for end-of-year balance-sheet adjustments, was abnormally low. This stronger-than-expected loan demand currently may stem from poor business sales performance and further undesired inventory accumulations. But there are several other forces that may also sustain this pattern for the next few months, despite soft economic conditions.

One possible source may be depressed corporate cash flow, which, by reducing available internally-generated funds, can induce greater reliance on outside borrowing. For example, many smaller firms that are having difficulty meeting their interest obligations may be borrowing to capitalize interest payments. As a result, these firms will increase their level of borrowing each time they roll over existing loans. This phenomenon will lead to an acceleration of loan demand, which will persist until business sales and earnings recover, enabling these firms to become more solvent.

Another source of increased demand has been borrowing to finance acquisitions. While these loans are sporadic and of a temporary nature, a depressed economy contributes to the circumstances that make takeovers more likely. Because stock prices tend to reflect investors' expectations of future corporate earnings, they are more likely to be depressed now, and the market value of many firms' productive assets can consequently fall below their replacement value. As a result, more successful firms may find that acquisitions are a cost-effective means of new investment.

The greater-than-expected strength of short-term credit demand also reflects the unattractiveness of the long-term bond market as an alternative source of funds. The rebound in long-term interest rates, indicative of the market's continued nervousness about future inflation and bond price volatility, has tended to prolong reliance on short-term credit. In addition, the number of downgradings by rating agencies has increased dramatically in recent weeks. Questions about credit quality raised by these actions will also tend to curtail the issuance of long-term debt. Indeed, both of these developments are already being reflected in current market activity: Despite the heavy January forward calendar, practically no new bond issues have actually been brought to the market. Without an improvement in long-term rates or in the credit quality of issuing corporations, it is unlikely that the bond market can serve as a vehicle for reducing the borrowing pressure that is now concentrated in short-term maturities.

CE OF PAYMENTS		MONEY AND BANKING							COUNTRIES
use of IMF credit, mil- ns of dollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	money supply(M1)	central bank rate (January 27, 1982)	exchange rate in U.S. dollars (January 27, 1982)	current monetary conditions	
0	Current-account deficit down through Sept. 1981; export orders strong.	Nov.	+ 7%	Sept.	— 1%	6.75%	.0623	Interest rates continue to move in tandem with German rates.	Austria
0	Export prospects poor in view of overvalued franc.	Dec.	+ 8%	June	+ 7%	14.00%	.0254	Rates ease as pressure on franc subsides.	Belgium
369	All time record current-account surplus estimated for 1981.	Dec.	+12%	Sept.	+12%	13.937%	1.8680	High level of real rates suggests imminent declines.	Britain
0	1981 Jan.-Sept. current-account deficit was kr. 8 billion, vs. '80's kr. 11.4 bn.	Oct.	+12%	July	+14%	11.00%	.1311	Current-account deficit forcing tight monetary policy.	Denmark
67	Jan.-Nov. 1981 trade deficit was fmk. 1.7 million vs. fmk. 5.5 million year ago.	Nov.	+10%	July	+ 7%	9.25%	.2240	Stable exchange rate allows policy to remain restrictive.	Finland
0	Heavy trade deficit in latter 1981 will widen further over next six months.	Dec.	+14%	Aug.	+12%	9.50%	.1691	Stable Franc in EMS permits lowering of domestic rates.	France
0	Exports and export orders rise briskly; current account now back in surplus.	Dec.	+ 6%	Sept.	— 1%	7.50%	.4300	Lombard rate reduced by ½ point, despite strong dollar.	Germany
1,349	Private capital inflows slow down in second half of 1981.	Oct.	+31%	n. a.	—	20.50%	.0185	Credit policies set to ease.	Greece
0	Jan.-Nov. trade deficit in 1981 was £1.7 billion vs. £1.2 billion year earlier.	Aug.	+20%	Oct.	+ 6%	16.50%	1.5250	Commercial banks' required liquidity ratios raised.	Ireland
0	Export prospects brighten; current-account deficit to fall markedly in 1982.	Dec.	+18%	Aug.	+ 9%	19.00%	.000803	Money remains tight.	Italy
0	Current-account surplus set to rise as export competitiveness improves.	Dec.	+ 7%	Sept.	0	8.50%	.3953	Interest rates ease in wake of lower German rates.	Netherlands
0	Trade surplus in 1981 was kr. 13.7 billion vs. kr. 5.7 billion in 1980.	Nov.	+12%	Aug.	+13%	9.00%	.1684	Monetary policy remains restrictive.	Norway
56	Crawling peg devaluation increased to 0.75% per month.	Sept.	+24%	June	+24%	18.00%	.0150	Monetary growth remains high.	Portugal
184	1981 current-account deficit was $5.3 billion; 1982 deficit forecast to decline.	Oct.	+14%	Sept.	+11%	8.00%	.0102	Funds still freely available; important rates firm.	Spain
0	Jan.-Nov. 1981 trade-deficit was kr. 1.3 billion, vs. kr. 11 billion year earlier.	Oct.	+10%	n. a.	—	11.00%	.1763	Monetary conditions eased no further.	Sweden
0	Strong exports and inventory cutback bolster trade balance significantly.	Dec.	+ 7%	Sept.	— 5%	6.00%	.5390	Central bank uneasy over strong Swiss Franc vs. DM.	Switzerland
0	Government repays U.S. $ debt to Canadian banks	Dec.	+12%	Sept.	— 1%	14.72%	.8357	Prime rate reduced to 16.5%.	Canada
0	Current account in 1981 was in large surplus.	Dec.	+ 9%	Dec.	+ 6%	12.00%	—	Interest rates jump as money accelerates.	United States

World Interest Rates

market rates of Jan. 27, 1982; bond yields as of Jan. 22, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	14.72	13.937 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.50	6.00	5.50
Day-to-Day Money	14.00 January 28	14.50	14.50	9.85	15.125	10.00	20.625	9.75	6.50	6.75
Treasury Bills 91-day, Middle Rates	12.77 discount basis	14.35	13.26	15.00	n. a.	n. a.	19.50 120-days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	13.00 finance paper discount basis	14.75 finance paper 15% tax w/h	12.90	13.90 Certified	15.25 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.40	14.75 15% tax w/h	13.812	13.90 Certified	not traded	9.90	23.40	no market	8.75	no market
Government Bonds Long-term, new and old issues, average yield	14.64	15.82	14.97	11.216 20% tax w/h	15.98	9.86	20.88	11.21	5.42	7.470
Industrial Bonds prime, long-term, new and old issues, average yield	15.80 Aa Industrials	17.00	16.19	17.583	17.28	9.95	20.36	12.50	6.325	7.18
Bank Short-Term Rate to Best Borrowers (prime rate)	15.75	16.50	15.50	18.00	16.85	14.00	22.50 ⅛ quar'ly fee on outstdng.	12.00	9.9375	6.00
Bank Time Deposits 3-month	13.875 Cert. of Dep.	14.50	14.562	15.10	15.25	10.20	10.75	10.50 large deposits	7.50 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	15.1875	no market	14.50	no market	15.875	10.3125	no market	10.375	9.00	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8357	1.8680	.0254	.1691	.4300	.000803	.5053	.5390	.004349
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.239 *D*	.959 *D*	4.483 *D*	1.174 *D*	4.527 *P*	7.426 *D*	4.86 *P*	6.042 *P*	8.303 *P*

Eurodollar Deposits
(London, interbank, bid)

January 28

7-day	14.00
1-month	14.50
3-month	14.0625
6-month	15.50

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	+ .651
U.S.-Canada Treasury Bills	− .681
U.S.-Canada Finance Co. Paper	−1.308
Eurodollars-U.K. Local Auth. Deposits	n. a.

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.875
Over 7 yrs.	16.25
DM Bonds	
7 yrs. and under	10.50
Over 7 yrs.	10.00

Gold Price

London afternoon fixing

381.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	8.9 (Dec.)	12.1 (Dec.)	12.0 (Dec.)	14.0 (Dec.)	6.3 (Dec.)	17.9 (Dec.)	6.6 (Dec.)	3.6 (Nov.)
Industrial production*	−4.7 (Dec.)	−2.9 (Nov.)	0.5 (Nov.)	−1.5 (Oct.)	0 (Nov.)	−0.3 (Nov.)	2.6 (March)	6.0 (Oct.)
Trade balance† *(billions of local currency units)*	−$4.41 (Nov.)	C$1.2 (Nov.)	£0.33 (Dec.)	−FF6.43 (Nov.)	DM3.95 (Nov.)	−Lit.1,150 (Nov.)	SF0.24 (Dec.)	¥139 (Nov.)
Money supply (M1)*	6.3 (Dec.)	−3.7 (Nov.)	10.7 (Nov.)	15.8 (Sept.)	−2.2 (Nov.)	8.9 (August)	−7.5 (Oct.)	8.4 (Oct.)
Velocity of money (M1)*	12.7 (March)	6.7 (June)	10.2 (Dec. '80)	n. a.	1.3 (June)	4.5 (June)	n. a.	2.7 (June)
Reserves minus gold *($ million, change from previous month)*	750 (Nov.)	1,730 (Nov.)	438 (Nov.)	114 (Nov.)	336 (Nov.)	−232 (Nov.)	1,002 (Nov.)	481 (Nov.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Structural Imbalance Shackles Israeli Economy

The Israeli economy rebounded from its dismal 1980 performance early in 1981, then faltered later in the year. Rekindled inflation put a squeeze on personal incomes, export growth slumped with the worsening recessions in Europe and the United States, and unemployment reached its highest level in more than 10 years. To be sure, some revival of economic activity in the second half of 1982 now seems likely. But real growth for the year is expected to remain relatively weak by historical standards. And the dual threat of a reacceleration of inflation and a widening of the perennial deficit in the current account of the balance of payments overshadows the current economic outlook.

The scope of any measures the authorities might take to remedy these problems is limited by a basic structural imbalance in the economy that stems from a burgeoning public sector and continued heavy dependence on foreign trade. Furthermore, the precariousness of the political situation in the Middle East precludes any dramatic policy action in the near term to correct that imbalance.

The severity of Israel's economic problems has only become apparent in the last few years. Prior to the late 1970s, the nation enjoyed robust real growth, owing largely to the government's growth-oriented policies aimed at securing full employment for a rapidly expanding population. In the 1960s, the average annual growth in real GDP was more than 9%. Even with the severe world recession of 1973-75, real annual growth over the last decade averaged 6%.

Two developments forced the government to abandon its high growth strategies in the late 1970s: The inflation rate shot up into triple digits and the second oil-price shock—coupled with stepped-up defense imports—widened an already gaping current-account deficit. Restrictive measures implemented at the end of 1979, which slowed economic growth, helped to narrow in the current-account gap in 1980 and 1981. But the inflation rate has remained stubbornly above 100%.

In discussions of proposals for the state budget for fiscal year 1982-83, Finance Minister Yoram Aridor last week warned that without significant cutbacks in public expenditures, prices could again double in the coming year. The public sector in recent years has consumed an increasing portion of Israel's scarce resources—at the expense of an innovative private sector, still in its expansion stage. But with more than one-third of the budget committed to defense spending, and another third obligated to servicing the public debt, the government has little latitude for economizing. Thus, the burden of adjustment has been hoisted upon the private economy.

In recent years, adjustment has been postponed through running a current-account deficit. And there is a temptation to continue along this path as long as that deficit can be financed. Given Israel's politically strategic position, there is little doubt that financing aid—either in the form of grants or loans—will be forthcoming. Nevertheless, the large and growing foreign-debt burden (over $18 billion or some 90% of GDP at the end of 1981) places added pressure on policymakers to take some sort of corrective action.

Policy-induced fluctuations

Determining appropriate policy in such an environment is not an easy task. And the roller-coaster-like path of the Israeli economy over the past two years, largely, reflects developments in economic policy.

Following buoyant growth and rapidly escalating inflation in the late 1970s, the government implemented a number of restrictive monetary measures that threw the economy into decline through the first half of 1980. Private consumption for the year slumped 3.4% in real terms. And the volume of fixed investment plunged 9.4%. Exports, which rose some 6% in volume terms, offset partially the decline in domestic demand. And increased government spending—chiefly defense outlays associated with the military redeployment in the Negev desert—helped compensate for the slack in private activity. Overall, real GDP growth in 1980, despite some revival of activity in the latter part of the year, slowed to 1.8% from 4.2% in 1979.

The recovery that began in the second half of 1980 was given an added boost in the early part of 1981 from a number of policies instituted by the then-new Finance Minister Aridor. These included reductions in income taxes and purchase taxes on durable goods and an increase in government subsidies paid on a range of basic commodities. Over the first half of the year, these measures restrained monthly increases in the Consumer Price Index to under 5%. However, later in the year, when some of these policies were partially reversed, economic activity flattened out and the inflation rate again soared to over 10% in some months. Unemployment climbed to over 5%—its highest level in more than 10 years—adversely affecting expectations and prompting consumers to save more out of current incomes. Nevertheless, because of the strength of economic activity in the early part of the year, private expenditures increased some 7% over their depressed 1980 level. Export growth slowed somewhat to about 5%, as Europe's long-awaited recovery was postponed by a worsening recession in the United States. Overall GDP growth

Structural Imbalance Shackles Israeli Economy *(continued from page 7)*

for 1981 as a whole is estimated to have been somewhat over 4% in real terms.

Economic growth in 1982 is expected to show a reverse pattern to that experienced in 1981. Sluggish activity is likely to continue through the first half of the year followed by some recovery in the second half, as a rebound of the U.S. and European economies revives demand for Israeli exports. A reasonably restrictive monetary stance, combined with any new efforts toward fiscal stringency, will not engender a revival in business confidence. Thus, investment activity is not likely to make a comeback before midyear. Even with some pick-up in consumer spending and stockbuilding later in the year, real GDP growth for 1982 is expected to be a modest 3.5%.

On the inflation front, preliminary government forecasts predict that prices will rise at an annual rate of 90% in 1982. This would be an improvement over the triple-digit figures of the past three years. However, the results of past government efforts to contain inflation have been mixed; thus, the danger of reacceleration must be taken into account in making projections of economic performance.

As for the current account of the balance of payments, there are also indications that the progress made in 1980 and 1981 may be reversed. Sluggish economic activity over that period, combined with a heavy drawdown of inventories, helped to reduce the current-account deficit below $1 billion. But with export growth expected to weaken in 1982 and imports likely to rise as companies begin rebuilding depleted stocks, the deficit may widen to $1.0-1.5 billion. The deterioration may not become evident, however, before the second half of the year.

Dual dilemma

The challenge to Israeli policymakers for the 1980s is to design and implement policies adequate to counter the twin threat of a re-escalation of inflation and a growing current-account deficit. This assignment is made all the more difficult given that these two problems are linked via a structural imbalance in the economy.

The seeds of the current inflation were sown in the shadow of the Yom Kippur war and the subsequent four-fold increase in oil prices during 1973-74. Cost increases were absorbed and passed on in an atmosphere of buoyant economic activity. Nominal aggregate demand, kept high by a growing budget deficit in the aftermath of the war, was supported by monetary expansion. Inflation accelerated sharply during 1978-79, before the first stage of the most recent round of oil price rises through 1980-81. The additional oil shock came on top of an economy that was already overheated with expectations geared to a further acceleration in prices. This, in turn, led to an explosion of wage increases above those guaranteed by Israel's indexation structure.

Policy measures undertaken in recent years by the Israeli authorities to counter the problem of inflation have taken two forms. First, to guard against the inefficiencies engendered by unanticipated inflation, the widespread system of indexation has been extended. Second, through 1979 and 1980, determined efforts were made—at great political cost—to reduce the growth of the government budget and curtail monetary growth. Ceilings were placed on the expansion of non-directed credit, and a 12% surcharge was imposed on foreign currency borrowing.

More recently, the officially declared approach to curbing inflation has been one of gradualism, emphasizing further efforts to trim the budget deficit. But Israel's continued strong defense needs and the high cost of servicing the national debt mean that cutbacks must be at the expense of social and industrial programs—a difficult political task.

Given this constraint, the burden of any deflationary adjustment policy is likely to continue to be borne by the private sector just as in 1979 and 1980. But at the same time, for strategic reasons, Israel must remain a high-employment, growth-oriented economy. This situation, added to the country's almost total dependence on foreign sources of energy, is likely to postpone any serious attempts to come to grips with the persistent balance-of-payments problems.

Policy prospects

The structure of the Israeli economy and the political constraints on policy do not provide a great deal of hope at this time for much of an improvement in the long-term economic situation. Economic growth in the 1980s is likely to be below the historical average. The current-account problem will persist, at least in the short-run, increasing Israel's need for overseas finance. Political and strategic considerations are likely to prevent serious financing difficulties, however.

Nothing short of a radical restructuring is required to alleviate Israel's inflation and balance-of-payments difficulties. But such a dramatic change does not appear to be close at hand. It had been hoped that the Camp David Peace Agreement would enable resources to be shifted away from defense, hence reducing the government's borrowing needs. However, the generally unsettled situation in the Middle East and the unresolved dispute over Palestinian autonomy continue to make such a development extremely unlikely. Thus, economic policy is expected to follow a "middle way," with a gradualist approach to the reduction of inflation encompassing mildly deflationary measures.

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